

JANUARY 2013

CAPITAL MARKETS UPDATE | Last year was another excellent year for virtually all capital markets. Even in the face of concerns over the Fiscal Cliff and the future of the Eurozone, the S&P 500 rose 13.4% for 2012 and most major equity indexes—domestic and foreign—were up by double digits as well. This bull market has now continued for almost four years and equity indexes have doubled during that period. Of course, we were coming out of a huge hole created by the financial collapse. As a result, this run-up has been characterized as **the most disrespected bull market in history**. Other capital assets were higher as well. Fixed Income and Real Estate showed positive returns for the year.

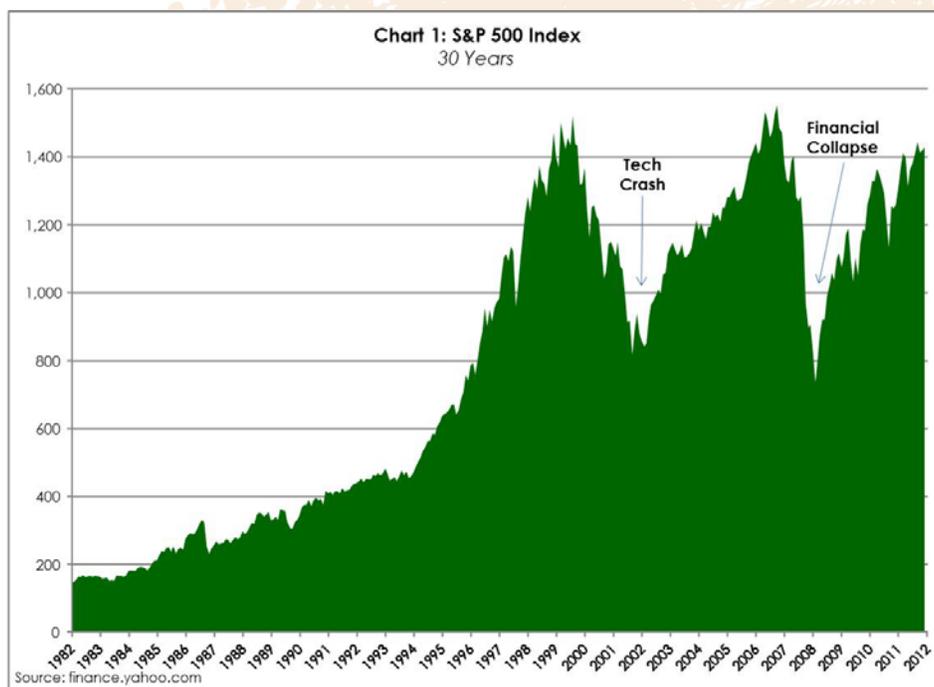
INVESTMENT REVIEW AND OUTLOOK—TAILWINDS AND HEADWINDS | Now that we're into the new year and the Fiscal Cliff was averted, it's a good time to step back and take account of the investment environment—where we've been and where we're headed. This is a particularly interesting period—as Congress and the President reached an agreement on a tax package; however, as we know, there are ongoing issues to be addressed, including the National debt ceiling.

As Arbor clients well know, we don't try to guess short term market turns: reading tax and economic tea leaves is a dangerous business. There is no way to predict where we're headed week-to-week or month-to-month and doing so usually leads to costly investment mistakes.

Longer-term issues and trends are not easy to discern either although they usually produce more investment information. In this regard, let's consider what has happened in the capital markets over the past three decades, and then look ahead based on what we know.

A LOOK BACK—TAILWINDS | Stocks have risen significantly over the last thirty years. As Chart 1 shows, even with the technology stock crash in 2000-2002 and the financial collapse in 2008, the US Large Cap market is almost back to historic highs. And while Developed International and US Small Cap Equities have had a somewhat different return pattern, the general trend is similar. Looking back, investors have enjoyed significant tailwinds which have supported these returns.

- **Demographics.** During this golden economic era the Baby Boomer generation in the US created new households, hit their peak income and purchasing years and worked to produce significant advances in science, technology and business.
- **Technology.** Who could have imagined the productivity gains the internet has produced? Every corner of our lives has been transformed from the way we lived before computers. Having virtually all human knowledge now at our fingertips is an amazing development that will be cited by future historians to explain the vast global economic and social changes of the past thirty years.



- Emerging Markets.** The fall of the Iron Curtain in the late 1980's, together with the emergence of state capitalism in China have created a huge global impact. Aided by technology advances, developing economies have generated waves of competitive companies and masses of consumers which have significantly impacted world markets.

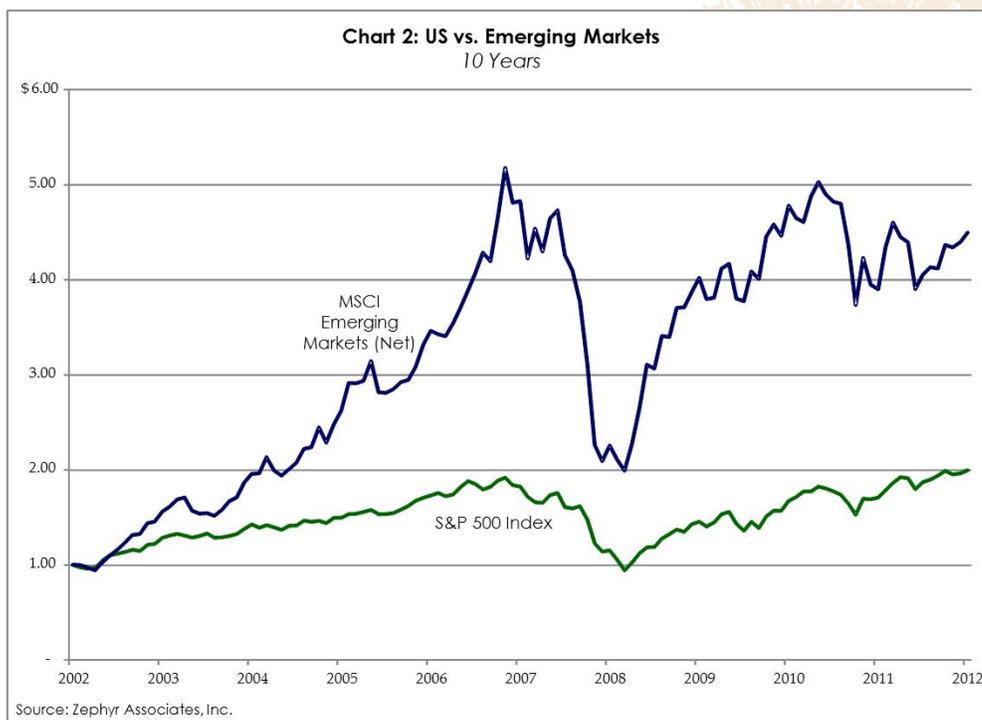
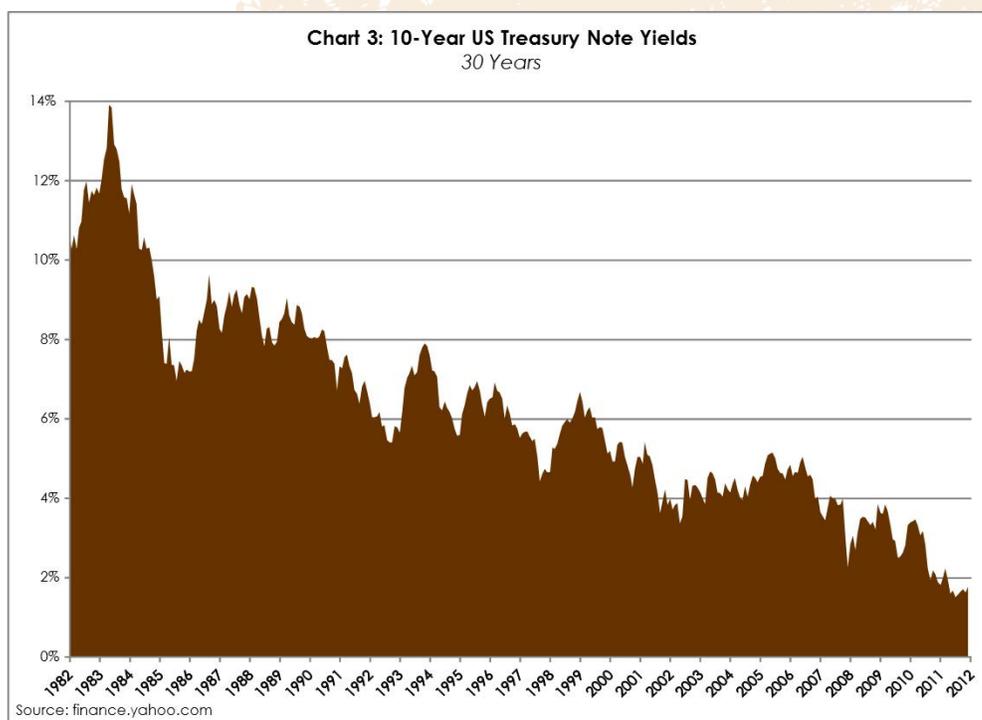


Chart 2 shows the cumulative total return of \$1.00 invested in the MSCI Emerging Markets and S&P 500 stock indexes since 2003. As one can see, the difference has been dramatic. Most Arbor clients have shared in this relative prosperity by having some portion of assets invested in the emerging markets sector.

- Interest Rates.** The last thirty years have witnessed a fundamental downward slide in overall interest rates world-wide. Declining inflation and interest rates coupled with aggressive monetary easing by the Fed have provided significant tailwinds for equity, real estate and especially bond markets. Chart 3 shows this trend for 10-Year US Treasury Note yields.

- Debt Financing.** The developed world has been on a debt-fueled spending binge. Governments, corporations and households accumulated significant debt burdens which helped support accelerated economic growth over this period. We're now dealing with the impact of our weaker balance sheets and slower economic growth.



Quarterly Newsletter



A LOOK AHEAD—HEADWINDS | It is reasonable to expect changes in the very factors which have served as catalysts in the past to stunt growth in the developed economies going forward and dampen some asset class returns. It's a bit like riding your bike down the beach—with the wind, then turning back to come home into it—two very different experiences! We may be at an inflection point where some of the positive trends we have enjoyed for so long may abate or in some cases reverse.

To briefly review the specifics:

- **Demographics.** As the Baby Boomers retire, they (we) switch from active producers and spenders to AARP members who expect increases in Medicare and Social Security.
- **Technology.** Productivity advances may be slowing and we have now automated many of our traditional jobs away.
- **Emerging Markets.** The growth rate of the developing economies is slowing. Many of them are now trying to change from production-based to consumption-based economies which brings new challenges (political, social and economic).
- **Interest Rates.** Though bond yields can certainly go lower, the path of least resistance is likely to be higher. While it is unclear when and how fast rates will rise, higher interest costs may dampen corporate earnings and consumer spending. This may negatively impact stock and bond values.
- **Debt Financing.** The US government's Debt to GDP is now at 100%. Simpson-Bowles has clearly pointed out the pitfalls of not dealing with debt and deficits and the debate continues about the right path and shared sacrifice that is required to reduce debt to sustainable levels in the US and other developed economies.

INVESTMENT IMPLICATIONS | Does this mean that we're in for an extended period of investment losses and negative returns? It's possible. Or could there be unforeseen developments which would positively change this picture? (After all—we don't know what we don't know.) Again, it's possible. But we believe those two scenarios are *tails on the bell-curve of probabilities*. The most likely scenario is **slower growth** than we are used to, **increased market volatility**, and **lower overall investment returns** than we've experienced over the past two decades.

As investors, our best strategy is not to try to fight these trends with heroic tactics but to manage our return expectations and strategically position portfolios accordingly. At Arbor, we are using mid to high-single digit equity returns and low to mid-single digit bond returns for planning purposes over the next ten years.

While each client has a custom asset allocation, this scenario has led us to generally reduce our allocation to both equities and bonds and increase the allocation to *alternative investments* to provide greater diversification and increased stability. Increasingly, we are adding inflation protection and emphasizing shorter duration in bond portfolios. Rising bond yields can be an opportunity if we are positioned to benefit over the long haul (don't lock in low yields for a long time). Last but not least, we continue to be passionate about enhancing the tax efficiency of client portfolios—this discipline will be even more valuable now with higher tax rates.

Looking back, it now seems as if investing in the 80's and 90's was easy. In the face of potential macro tectonic shifts, thoughtful **strategic investing** is more important than ever.

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